



NAVIGATING TRADE WARS: AN MSME PERSPECTIVE

ABSTRACT

The International Council for Small Business (ICSB) predicts that in 2019, the trade dispute between the United States (US) and China will have a major impact on MSMEs. This thought piece presents an overview of the trade dispute and discusses how it affects the global economy, Australia and MSMEs in Australia.

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Introduction

The International Council for Small Business (ICSB) is a non-profit organization devoted to continuing management education for entrepreneurs and small business. Founded in 1955, the ICSB was the first international membership organization to promote the growth and development of small businesses worldwide.

Each year the ICSB polls educators, researchers, policy-makers and practitioners from around the world to anoint the top ten trends affecting micro-, small and medium sized enterprises (MSMEs). These trends highlight the way in which the continuous flux of the contemporary marketplace is constantly inundating MSMEs with a myriad of challenges.

This year, the ICSB predicts the trade dispute between the United States (US) and China will have a major impact on MSMEs¹. Recent developments have made it clear that Australia is not exempt from the effects of the dispute. The Australian share market suffered an approximate A\$90 billion loss after China allowed its currency to drop to its lowest level in a decade.²

Considering this and the prediction by the ICSB, this paper will give an overview of the trade dispute and discuss how it affects the global economy, Australia and MSMEs in Australia.

The US-China trade dispute

The current trade dispute between the US and China began in January 2018, following US grievances over China's model of economic development that had come to include, higher tariffs on US imports, subsidies to private companies – which disadvantage foreign competitors, and allegations from American multinationals of the forced transfer of technology to Chinese firms.³

As the dispute has progressed, so too has its intensity. With sanctions of increasing severity imposed by the US, followed by retaliatory action from China. So far, the US has imposed the following tariffs:

- 20%-50% on solar panels and washing machines,
- 25% on steel,
- 10% on aluminium,
- 25% on US\$50bn of mainly intermediate Chinese goods
- 25% on US\$200bn of Chinese goods, including agricultural and intermediate goods, fabrics, chemicals and some electronics.

China has retaliated by placing various tariffs on US exports such as:

- 25% on US\$50bn US agricultural exports and some commodities
- An average of 15% on US\$60bn of US agricultural goods, chemicals and machinery.⁴

The effect of these tariffs has been a considerable reduction in bilateral trade between the two countries. Chinese imports targeted by US tariffs have fallen on average by 31.5%.⁵ Retaliatory tariffs have impacted US commodity exports, causing a 60% reduction.⁶

Some sectors have been particularly affected. US oil exports to China have fallen dramatically since August 2018, but it is American soybean farmers who have felt the impact the most. China is the biggest importer of soybeans in the world, importing 30 times more soybeans than the second biggest soybean importer, the European Union.⁷ US soybean exports to China, which totalled US\$13.9 billion in 2017,⁸ have plunged to almost zero, and unlike the case with the oil sector, exporters have not been able to make up the fall in Chinese demand by exporting more to the rest of the world.⁹

US imposed tariffs on China are expected to generate an extra US\$40 billion in revenue for the US government in 2019.¹⁰ However, multiple studies have found that the cost of the tariffs have been passed on to US consumers, who are paying for it through increased prices of goods.¹¹ For example, the tariff placed on washing machines was found to have

increased the price per unit by US\$86, while incidentally increasing the price of clothes dryers by US\$92.¹²

Roughly 1800 jobs were created as a result of this policy, however given the total cost to consumers was approximately US\$1.5 billion, each job cost US\$815,000.¹³ Moreover, it was found that the trade dispute negatively affected American incomes by US\$6.9 billion in the first 11 months of 2018, while also reducing US GDP by 0.04%, which equates to a loss of US\$7.8 billion for the US economy.¹⁴

Impact on the global economy

The trade dispute between the US and China is expected to have a detrimental impact on the global economy. Economic modelling suggests that as US and Chinese bilateral exports decline due to the imposed tariffs, prices for imported goods in those countries will rise, this diverts consumer demand to domestic goods, which in turn increases the exchange rate, therefore reducing the competitiveness of exporters in the two countries. As demand for foreign goods in US and China diminishes world output decreases and global employment drops.¹⁵

Similarly, the International Monetary Fund (IMF), in its April 2019 World Economic Outlook, cites increasing uncertainty from the trade dispute as a major factor in its projection for diminished growth in 2019. Uncertainty causes problems because companies delay projects and reduce investment. This is because the high costs of reversing investment make it more prudent for firms to merely observe events unfold.

Likewise, households may reduce consumption as they wait for less uncertain times.¹⁶ The uncertainty caused by the trade dispute is a reason the IMF has projected global economic growth to slow to 3.3% in 2019, down from the 3.6% in 2018.¹⁷ It was also the catalyst for investors to move aggressively from stocks to the safety of government bonds after China let the yuan drop to its lowest point in a 11 years.¹⁸ This came in retaliation to US President Trump announcing another 10% tariff on the remaining US\$300bn of Chinese imports. The effect of which caused the US and Australian stock markets to drop by 3% and 2.9% respectively.¹⁹

While global output on the whole is projecting downward, the US-China trade dispute has provided opportunities for some. It is estimated that upwards of US\$165 billion dollars of trade will be redirected in an attempt to avoid the tariffs imposed during the conflict.²⁰ As imports and exports between US and China have fallen, US imports from Vietnam have increased by over 40% in the first quarter of 2019.²¹ This has the potential to accelerate Vietnam's growth as companies attempt to shift some of their

production out of China to avoid the accelerating costs.ⁱ China has also made itself more appealing for overseas exporters. In contrast to its tariff increase on imports from the US, China has substantially reduced tariffs for all other overseas exporters.²²

Another region that may benefit from the trade dispute is the European Union (EU). Modelling shows EU imports and exports from both the US and China increase during the dispute, which in turn increases EU output and employment.²³ In consideration of this, Australia's government and businesses should also explore how to maximise the benefits of any opportunities that may arise from the dispute.

Trade dispute impact on Australia

The protectionist stance and the imposition of tariffs by the US in 2018 did not come as a surprise. In mid-2017 the Productivity Commission produced a research paper examining the potential impact on Australia of US tariff increases on China.²⁴ The paper reported that Australia as a whole, would be little affected once the reorganising of world trade, such as that stated above, had passed.²⁵

More recently, JP Morgan estimated the direct and indirect effect on Australian GDP. Similar to the Productivity Commission's paper, they estimate that the dispute would negatively affect GDP by -0.04 percentage points this year and -0.03 percentage points next year, equivalent to A\$13.3 billion.²⁶

The reasons for the modest estimates are the countervailing forces at work as the Australian economy adjusts to the disruption to the world trade status quo. As incomes in US and China decline so does their overall demand for Australian exports, however there are a number of price effects that compensate for this. Furthermore, as the cost of Chinese exports to the US rise and vice versa, US and Chinese demand for Australian exports increases. There is also the impact that as the costs of US exports increases, demand for Australian exports by other countries increases. As the world price of Chinese exports declines, Australian consumers benefit from the price falls in the products that China exports to the United States, as they are the types of goods that dominate Australian imports.²⁷

ⁱ A *Joint Statement on the Establishment of a Strategic Partnership between Australia and Viet Nam* was signed in 2018, which puts the Australian Government in a good position should they desire to further expand trade, investment and development cooperation with Vietnam.

Impact on Australian MSMEs

The reorganisation of world trade resulting from the dispute will have a varying effect on different levels of the economy. On a micro-level, impacts from the trade dispute will be felt differently on a case-by-case basis. For example, MSMEs who are involved in export chains that have relied on Chinese growth should be aware of the negative implications of any weakness in the Chinese economy.

Most exposed is the resources sector, as China is Australia's top export destination, comprising 51% of the market. Which means that a reduction in China's growth may affect MSMEs that are involved in the oil, gas and energy resources sector and mining equipment, technology and services.²⁸ Similarly, MSMEs involved in industries such as education and tourism, that have relied on the increasing wealth of the Chinese middle class may also be at risk.

Although, the Chinese governments stimulus in early January – when China's central bank made its biggest single-day cash injection into its economy – along with other infrastructure investment measures currently under way, are a part of a strategy to compensate for any slowdown of the economy resulting from the dispute with the US.²⁹

Conversely, there are opportunities for MSMEs in industries where US and Chinese tariffs create pricing advantages for Australian exporters. The food and agribusiness industries are such sectors, where demand for products such as Australian wines, soybeans and grains may grow due to the Chinese retaliation against US imports.³⁰ Australian MSMEs in these industries should consider reaching out to overseas business affected by the tariffs that are searching for alternative suppliers.³¹

Additionally, any Australian MSMEs involved in the rare earth extraction and export process, may have an opportunity as China threatens to suspend its rare earth supplies to the US. Rare earths are an essential input into a wide range of high-technology products, across the electronics, renewable energy, petrochemical and defence sectors. Currently, China produces 79% of the world's rare earth oxides, making Australia, the world's second largest producer (15%), central to the diversification efforts of US companies that are dependant on supplies from China.³²

Potential actions

Australian policy makers have a number of options available in response to the US-China trade dispute. Thus far, Australian Treasurer Josh Frydenberg has chosen to advocate for the international rules-based framework to be maintained, while also espousing the benefits of free trade.³³ Yet, in regard to policy, he has adopted a wait-and-see approach.

While it may be conservative and responsible to express an abundance of caution in relation to the potential impacts of the dispute. Nevertheless, there seems to be scope for the Commonwealth Government to be more proactive in respect to facilitating opportunities for MSMEs. It is possible for policies to assist MSMEs on both a macro and micro economic scale.

1. Proper functioning world trading system

Australian officials should explore how best achieve a world trade system based on multilateral rules. Australians have benefitted greatly from decreased tariffs and the country's integration into the global economy. In 2016, average household incomes were better off by over A\$8,000 and production 5.4% (A\$85 billion) higher than it otherwise would be without a decline in tariffs since 1986.³⁴

Even though the continuation of the trade dispute will have a negative long-term effect on the economy, perhaps the biggest long-term threat to Australia, is if an agreement is reached between China and the US that prioritises managed trade between the two countries. Currently, the US is Australia's biggest investor and China is Australia's largest export market.³⁵

An agreement based on managed trade between the US and China would see increased trade between China and the US, diminishing the benefits Australia receives from its free trade agreements with those countries and locking out Australian exporters in beef, LNG, iron ore and coal.³⁶ This has the additional possibility of fostering a new bilateral world system with interlocking spheres of influence, that would marginalise Australia to nominal US ally and Chinese commodity supplier.³⁷

A multilateral trading system with a robust World Trade Organization capable of settling global trade disputes and the promotion of international rule of law, fair competition, predictability and transparency should be a primary consideration for Australia in its reaction to the trade dispute.³⁸

2. Minimise risks

The US-China trade dispute poses risks for MSMEs that are in sectors that rely on Chinese growth, US investment or that are in an industry sensitive to the general economic conditions.³⁹ With proper guidance, MSMEs will be able to plan for the effective mitigation of these risks. The Australian government should consider running an educational campaign to inform small businesses of the situation.

Education could be in the form of information programs or resources that are distributed, containing information to assist businesses with their decision making. In particular, MSMEs should be encouraged to take caution when considering expanding capacity and taking on more debt, while also possibly diversifying their supplier and customer base across different regions and countries where possible.⁴⁰

Programs or resources developed for MSMEs may also include information on how they can better leverage free trade agreements (FTA) in accordance with the recommendations made by the 2019 Parliamentary Inquiry into small and medium enterprise access to FTAs.⁴¹

3. Capitalise on opportunities

To counteract the negative effects of the trade dispute between the US and China, policy makers should consider creating incentives for Australian MSMEs in sectors that stand to benefit from the imposition of tariffs by the US and China.

Decreased activity from world's two largest economies and the inherent uncertainty brought with it, is set to slow down the global economy.⁴² Yet there are real opportunities for Australian businesses to fill supply and demand gaps caused by higher tariffs.

A number of economic models predict that, while Australia will be affected by trade dispute, it will not be felt as much as in other regions.⁴³ This should prompt the Australian policy makers to put measures in place to ensure this eventuates.

Incentivising businesses, including MSMEs, to maximise the opportunities that arise out the trade dispute should be a priority. Incentives may include, grants for roadshows that showcase Australian products to overseas markets either in Australia or abroad, bonus grants for new overseas contracts won and subsidies for businesses to expand capacity.

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